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SIPDIS

TREASURY FOR INTERNATIONAL AFFAIRS - CPLANTIER
NSC FOR MERKEL AND MCKIBBEN

SENSITIVE

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TAGS: EFIN EPET ECON TU
SUBJECT: Turkey's Policies Moderate Impact of High Oil Prices

REF: SECSTATE 186514

This cable has been coordinated with Congen Istanbul.

1.(SBU) Summary: With Turkey importing over 90% of the oil it consumes, higher energy prices have aggravated Turkey's large and growing current account deficit. A recent Standard and Poor's analysis named Turkey as one of the most vulnerable Emerging Market countries to higher energy prices. However, Turkey's high taxation of petroleum products, full pass-through of market prices and trade and investment ties with energy-exporting countries all mitigate the impact. End summary.

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High Oil Prices Exacerbate Current Account Concerns
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¶2. (SBU) As Turkey's other vulnerabilities--particularly its debt situation--have moderated, economists' concerns have increasingly focused on the large and growing current account deficit. Whereas the deficit was 5.1% of GDP in 2004, it is expected to rise to over 6% of GDP in 2005, despite real GDP growth of about 5%.

¶3. (SBU) The principal cause of the ballooning current account deficit is widely considered to be the flood of portfolio investment inflows, which drive up the exchange rate. The appreciation of the lira causes imports to grow faster than exports. The advent of sharply higher energy prices in 2005 has substantially added to Turkey's import bill, aggravating the current account deficit problem. Comparing January through August 2005 to the same period in 2004, out of a roughly $12 billion increase in imports, nearly $4 billion stemmed from higher energy imports (crude oil, petroleum products and natural gas). The dollar value of energy imports grew by nearly 50% from the same period in ¶2004. This result is hardly surprising: Turkey imports about 91 percent of its oil and a higher percentage of its natural gas. Looking at crude oil imports in isolation, the increase in the dollar amount was entirely due to higher prices: imported crude volumes actually declined slightly.

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Standard and Poor's Report Highlights Turkey's Vulnerability
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¶4. (SBU) Turkey's relative vulnerability to high oil prices was highlighted in a Standard and Poor's Report October 11 on the impact of higher oil prices on Emerging Market countries. Among these countries, the ratings or outlooks for only Turkey and Pakistan were considered threatened by current energy prices, with the source of vulnerability these countries' "external positions" (read current account deficit). The singling out of Turkey created a bit of a stir in Turkish financial markets.

Fiscal Impact Neutral to Positive

¶5. (SBU) However, a closer look at the report and other sources shows that the risks have been substantially moderated by other factors. First, from a fiscal standpoint, increased energy prices will not lead to an Indonesia-type situation, since there are no subsidies on petroleum products, natural gas or electricity. Nor are petroleum product prices administered. One of the IFI-sponsored reforms in Turkey is a complete pass-through of petroleum product market prices to the retail point of sale. Retail sales are also heavily taxed: one report on global taxation of petroleum products placed Turkey as having the eleventh highest tax burden on gasoline and diesel sales in Europe. When compared to Asian countries, Turkey had the second highest level of fuel taxation in all of Asia, after Hong Kong. The S & P report acknowledges that Turkey's fiscal situation is unlikely to be hurt by higher oil prices: although Turkey reduced the rate of its ad valorem

Special Consumption Tax (SCT) on petroleum products in 2005, revenues from petroleum taxes increased because of the increase in the underlying prices,.

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Pass-through of Market Prices Allows a Demand Response
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¶7. (SBU) The full pass-through of market prices combined with the high level of taxation, has another benefit besides its positive fiscal effects: it allows market forces to work and produce a demand response. Though energy demand tends to be inelastic around the world, the full pass-through is likely to produce greater efforts at conservation and investment in alternative energy sources over time. The full pass-through is a relatively recent reform: it dates from the beginning of 2005.

Inflationary Impact

¶8. (SBU) Higher oil prices have made the Central Bank's disinflation campaign that much harder. They were a factor in the Central Bank's slower pace of rate cuts in recent months, following its steady rate-cutting in the first half of 2005. The inflationary effects of higher oil prices seem manageable, however. For example, Morgan Stanley's Turkey analyst estimates their cost at 1-2 percentage points in the inflation rate this year, concluding higher energy prices will cause a slowdown in the pace of disinflation, not a burst of inflation.

Recycled Petrodollars Coming to Turkey?

¶9. (SBU) There are two other potentially mitigating factors arising from Turkey's proximity to-and relations with-the energy-exporting countries of the Middle East and former Soviet Union. First, Turkey typically is able to access energy prices slightly lower than those quoted on global commodity exchanges: in 2004, Turkey's average crude oil import price was $34.50 versus $38 for Brent Crude. Turkey is also able to access relatively inexpensive natural gas from Russia.

¶10. (SBU) The other mitigating factor, though harder to qualify, may end up being more important: there are signs Turkey is benefiting from increased trade and investment ties with cash-rich oil-exporting countries. Turkey's economic ties with Russia are increasingly important, and not just as a result of Russian gas sales. Turkish construction companies are active in Russia, Russia is the second most important country of origin for Turkey's critical tourism industry, the "suitcase trade" with Russians has long been a staple for Istanbul retailers, and Russian companies are increasingly looking for purchases in Turkey. Russian telecoms company Alfa has bought a large stake in Turkey's leading mobile telephony group, Turkcell.

¶11. (SBU) Turkey's attractiveness as a destination for Middle Eastern investors also seems likely to attract substantial investment. The highest-profile recent example of this was the Saudi Oger-led consortium, with its $6.5 billion bid emerging as the winning bidder of the Turk Telekom privatization tender in July. It is notable that the second place bidder was also from the Middle East: UAE-based Etisalat. In October, the Crown Prince of Dubai came to Istanbul and announced it would be investing in a huge business tower project with a $500 million dollar price tag (septel from Congen Istanbul). Portfolio flows from the Middle East are thought to be substantial, if hard to quantify. Many of these investors invest via European subsidiaries and funds such that the flows do not show up as Middle Eastern in origin in the balance of payments data. To the extent these investors are putting more money into Emerging Market funds, they are undoubtedly including nearby, fast-growing and now EU accession candidate Turkey.

Comment

¶12. (SBU) Turkey has mitigated the adverse impact of higher energy prices through a combination of passing through world energy prices and high taxes on petroleum products. Significantly, S&P's sovereign analyst for Turkey-as opposed to the global oil analysts who wrote the report-downplayed the Turkey-specific implications of his colleagues' report in an e-mail to econoff, saying there were many other factors in Turkey's overall vulnerability. His e-mail may be more significant than the oil analysts' warnings: market watchers have generally taken a more favorable view of Turkish risk since the October 3 start of EU accession negotiations. Fitch Ratings sovereign analysts recently visited on a periodic review, and have virtually ruled out a downgrade. They expect to either hold Turkey's rating at its current BB- with a stable outlook, or upgrade it

slightly.

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